

On the EU-maturity of Central Europe: perceived and real problems

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LÁSZLÓ CSABA

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EUROPE:

PERCEIVED AND REAL PROBLEMS

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László Csaba:

On the EU-Maturity of Central Europe:

Perceived and Real Problems

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On the EU-Maturity of Central Europe: Perceived and Real Problems¹

Introduction

Enlargement of the European Union is a broad issue of prime politics. What countries to admit, how and when, under what conditions will have long been debated before any accession materialises. These issues and the related argumentation, conducted at the policymaking level are subject of a different paper of this author (Csaba, 1998). The present piece is devoted to some of the more philosophical issues to be tackled at a different level of abstraction, that of applied economic theory. It relates to three most likely candidates for Union membership: Poland, the Czech Republic and Hungary, as reflected in the Commission's AGENDA 2000. These are called - in a somewhat arbitrary fashion - as Central Europe, in order to delineate them from less advanced transforming countries, that are not yet members of the OECD club of market economies. The paper is not empirical, but is meant to address a single, weighty theoretical issue: is the above described narrow Central Europe (with the possible inclusion of Slovenia) mature for a full Union membership by the first years of the new millenium? Is there an answer based on economic theory, rather than political tastes, to this question?

This paper was written at a time when the NATO decisions of Madrid as well as the official presentation of the avid of the Commission have by and large settled the dispute over the possibility of an eastward enlargement of Euro-Atlantic structures. Debates from now on will concentrate on the ways and means, scope, speed and other circumstances of enlargement. Thus it seems legitimate to skip what intially used to be the topic of a large body of literature, i.e. whether it is in the interest of either side to enlarge, and if yes, why and when. I take it as given that any such step is that of strategy, therefore its bits and pieces, taken one by one, do not add up to their structure. If the underlying logic is abstracted away, as in a part of more technical writings, the individual measures and their supportive arguments remain just as inconclusive, as individual human gestures torn out of their context.² The mutual commitment here is thus - first - taken as given. Second, I also abstract away the comprehensive issues of whether, when and how the Community is able to absorb new members, further if the institutional and other reforms contemplated currently suffice for an efficient mastering of the task. This is also taken here as

¹ Useful comments of H. Brücker, J. Kosta, W. Schrettl and H. Willgerodt are appreciated, with the usual caveats. This paper was presented to the conference of Verein für Socialpolitik, Ausschuß Wirtschaftsvergleiche in Breisach, 21-23 September 1997. Final version forthcoming in D. Cassel, ed.: Die europäische Integration als ordnungspolitische Gestaltungsaufgabe. Berlin; Duncker und Humbolt, 1998.

² Bringing a bunch of flowers may not represent a gesture of deeper sympathy, depending on the situation. Similarly, bringing debt GDP ratios down may or may not be a condition for integrational maturity.

given, although - as I tried to argue elsewhere (Csaba, 1997a and b) it is practically far more relevant a precondition for enlargement than any other single issue. The angle of analysis remains narrow and one-sided, with an exclusive focus on the readiness of the front-runner transforming countries for eventual Union membership. A third, no less important topic to be assumed away is that of not(yet) members as well as problems related to Russia, Ukraine and all of the post-Yugoslav states except Slovenia. The latter is a practical matter, and provided the theoretical structure of the analysis below is sound enough, the findings may be generalised so as to contribute to setting the conditions for possible future decisions on enlargement, as well as its limitations. Fourth, I also mostly disregard otherwise weighty issues of public choice for Central Europe, i.e. whether current ECU arrangements are necessary and sufficient conditions for laying the groundwork for their sustainable development. Low growth coupled with high unemployment in the 'target zone' may legitimate such theorising. But for the present purpose the Europe Agreements as binding international contracts are accepted in which would-be members already in 1991-92 compelled themselves to take over the (present and future) *acquis communautaire* rather than criticise it.³ If these are seen as irrational or triggering intolerable costs in case of enlargement, this is just another urge for internal reforms rather than to deny the feasibility of enlargement, on the dubious methodological ground of a status-quo extrapolation. For the present paper it is assumed, that a solution to this challenge can be, and indeed will be, found either via more spending or - more likely - by trimming previous entitlements when the new financing guidelines for the post-2000 accession period will have been set. The ways and means of attaining this goal also fall outside the scope of the present exercise, which is the fifth relevant explicit assumption/limitation of our reflections here.

Is Conventional Wisdom Full of Misperceptions?

If there is anything like 'conventional wisdom' on the eastward enlargement, this is a - mostly imprecisely formulated - impossibility theorem. Contrary to 'high flighing' politicians 'down to earth' economists produce arguments why Central Europeans could not, should not, or should not even want to join in, despite the explicit deliberations and the careful wording of the Treaty of Rome (on the latter cf. Balázs, 1996, Part I).

The classical summary of all possible arguments against an eastward enlargement is still the well-argued book of Baldwin (1994). Among many, partly valid and sophisticated, arguments the main thrust of his reasoning is that these countries are too poor, too populous and too agricultural to join. In a footnote, the author himself

³ This feature is sometimes seen as newcomers' perceiving the EU as the seventh heaven, which is, of course, wrong.

concedes that these `may not fully hold` for those 3 or 4 countries,⁴ which currently stand a good chance for being in the first round of Union enlargement. Using purchasing power parities rather than grossly and intentionally undervalued exchange rates, taking into account the very large irregular economies, as well as the impressive performance in the 1992-97 period, one can not seriously believe that the Czech Republic would need 20 more years to catch up with Portugal or Greece. Population may be a problem if Ukraine and the Balkans are covered (as by Baldwin). With the front-runners only we face a 65 mn population, quite in line with the Southern enlargement, which a then much poorer Community managed with reasonable success (Palánkai, 1997). Finally the 5-7 per cent of farming in GDP in the Czech Republic, Hungary and Poland is actually not that dissimilar from Southern EU members` ratios.

The problem of agriculture can be seen as a problem or a chance (Varga, 1992; Franke, 1997), as taking over the 1991 CAP could, indeed, have produced unprecedented surpluses in the farming sector. However, this is an unrealistic assumption.

First, producing capacities in would-be members dramatically decreased against, say, the mid-80s. Second, CAP reforms along the MacSherry lines will be inevitable under the 1994 WTO agreements and the forthcoming WTO round will surely invalidate any assumption extrapolating 1991 (or 1997) arrangements for the post-accession period. Third, even if the EU funds were theoretically available, the absorption capacity of the new members would be limited to draw all entitlements (Wagener/ Fritz, 1997). As signatories to both WTO treaties Central Europeans have already been forced to cut production and export subsidies and manage painful structural adjustment processes in their farming sectors. Following accession competition is likely to crowd out further parts of local output from their traditional domestic markets, which is not exactly the base scenario for a boom in the agricultural sector.

The poverty argument seems to have taken root much more than established trade theory or neoclassical growth theory would have justified. Both different factor endowments and the theory of endogenous growth prognosticate higher rather than lower growth rates for latecomer economies. This applies *a fortiori* if trade liberalisation and market size considerations are available (as in case of EU enlargement). Disregarding these fairly unsurprising and not exactly new findings

⁴ Short of a - currently unlikely - territorial settlement on Cyprus and a more forthcoming attitude of Slovenia the accession of these countries seems unlikely. Viktor Chernomyrdin's July 1997 Paris statement was the first indication of Estonia's improved chances, though the Baltic's do pose a special problem. For a similar unofficial view of the Commission cf. Also Die Welt, 11. July 1997. Thus, from the officially prioritised 6 applications only 3 seems to stand a good chance to be accepted in the first round, by 2002/2003.

two alternative views took hold. One brand is that of convergence programmes (Ludlow/ Gros, 1993). These simply switch off the entire mechanism of catching up and the political economy of orchestrating measures leading to it. They turn the question to its head by asking: how many years would it take for candidates to reach, say, 75 p.c. of EU-average levels? The answer is certainly biased downwards, at least for two reasons. First, it disregards the very large and palpable growth impetus of FDI that a mere prospect of membership may, and indeed will, trigger. Therefore domestic savings cease to be a compelling constraint on growth acceleration. Second, transformational recession (for details cf. Kornai, 1994) was a temporary and unique phenomenon in 1989-92, having depressed initial levels and expectations well below the realistic catch-up potential. Last but not least self-propelling catch-up due to institutional reforms and relocation of activities is already well under way, but not independent of integration at the microeconomic level. In sum, a convergence programme would like to see the outcome as a precondition, which is certainly the reverse reasoning. Unsurprisingly, authors of this line normally do not see how their maxims could (or ever will) be attained, as the very driving forces that may actually deliver this outcome are neatly abstracted away.

An alternative view in the same line is the argument on agglomeration effects (Tichy, 1997). In this approach both central and peripheric regions have a tendency to multiply and enforce their previous position. Thus any integration of the periphery presupposes a.) limitations of labour mobility (cf. below) b.) enhanced transfer spendings to ward off mobility. This new edition of Marxist economics disregards such fundamental facts of life as the emergence of two dozens of newly industrialised countries and the decay of some of the old metropolitan areas. There is little empirical and even less theoretical evidence that would lend support to this line of reasoning, besides the arbitrary assumptions built in the underlying models. Hong Kong, Taiwan or Singapore did not always used to be financial and services centres, and Belgium is certainly not what it used to be, neither is the US East Coast. In fact, while the arguments why trade liberalisation and market integration is always welfare enhancing are rather standard textbook knowledge, supported by microeconomic (networks, industrial organisation) considerations, the contrary reasoning is simply widespread, meanwhile hardly compelling. If anything the experience with German reintegration has proven, that the way through enhanced transfers cum regulated labour markets leads to an emergence of a Mezzogiorno-type of rent-seeking society, rather than an accelerated catch-up in the real world (cf. also von Hagen, 1995).

There are two further subdivisions or extensions of the poverty argument. One forecasts massive migration of people: a recent estimate for instance puts the potential to 340 to 680 thousand people from CEFTA (Brücker, 1997: 94). This finding may be easy to instrumentalise at the political level. Moreover, compared to

other forecasts, as those of the IMF, EBRD or EIU, it seems to underestimate the medium-to-long-term growth potential of the region. This finding also seems to be at odds with empirical experience in the EU of the 70s and 80s with lower propensity and possibilities and for moving over. Linguistic and cultural barriers, repatriation as well as labour market and residence permit measures⁵ all resulted much less flexibility of this factor than suggested above. Concurring analyses of US and EU empirical time series of the 1950-90 period (Gorges, 1993) have arrived to elasticity's of about one third of what the above quoted study relies upon. My point of criticism, however, is not directed to the econometric technique, to the numbers or its policy implications. Let us suppose: this is the final word in an ongoing international controversy. Even then, numbers must be interpreted in a macro context. And after all: should 0.5 mn people actually resettle to a community of over 350 mn - would that really be a serious external shock at the macro level? And if yes, is it the supply or the demand side that call for a radical treatment? In a technical argumentation it is hard to sell an argument depicting a mere 0.5 p.c. change as a serious external shock, even on the labour market.

A revised and extended version of the poverty argument goes as follows. Hard-pressed by their current account crises transforming countries have maladjusted their economic structures by opting for low wage policies and undervaluation. The resultant resource intensive export structures will be lastingly incompetitive on the international markets (Gabrisch, 1996). Joining this line others caution of a 40-60 p.c. jump in consumer prices, and the resultant cost-push inflation, should Central Europeans join in the EU (Havasi, 1996).

It has already been mentioned that the appreciation of exchange rate is, to some extent, an automatic process. Recent overviews of the export performance of transforming countries have evidenced both the quantitative and the structural advancement of the frontrunner countries (Kaminski/ Wang/ Winters, 1996). Hungarian corporate evidence also reflects major comparative advantages in the more rather than the less skilled groups. Thus FDI strategy is one of relocating R+D and other knowledge intensive activities, while simple jobs go to underdeveloped countries. SITC 7 group category has climbed from 13 to 42 p.c. in Hungary's exports to the EU in the 1989-96 period. This is not the picture of eternal slavery. As far as the price adjustment is concerned it is a fact of life that most of it has already taken place, true mostly in the upward direction. But in the longer run areas with comparative disadvantages prices should decrease (Cassel, 1996: 160-161), and they already started to do so, at least in relative terms, and where protectionist barriers do not counteract these (as in the farming, the textile on

⁵ Central Europeans have travelled enough in the 90s to be able to form rational expectations of their chances on say, the Spanish or the Finnish labour market. Thus migration potentials are likely to be lower than any technical figure would suggest, since the high rejection probability invalidates the use of those USA elasticity coefficient's that Brücker (1997) relies upon in his econometric analysis.

the steel sector they do). In sum, neither the maladjustment, nor the cost-push argument seems to hold for the frontrunners.

All in all, the more one believes in standard economics, and the less one takes existing arrangements reflecting casual social compromises (in East and West) for granted, the smaller is his willingness to buy the 'too poor, too populous, too agricultural' argument, and the less difficulty one sees in the welfare enhancing capacities of exchanges among countries on various levels of development. True, for this one often neglected quality of modern economics is positively required: the ability to distinguish (not to mix up) macro- and microeconomic levels of argumentation, which is anything but normalcy in policy discussions. The advent of the informational and electronics revolution makes the backwardness of physical infrastructure comparatively easy to tackle by the spread of new communications techniques, that also favour decentral smaller arrangement and individual initiative, against the scale economies and standardisation of the steel and textile period.

On the Meeting of the Copenhagen Criteria

In 1993 the Copenhagen Council set the criteria that are necessary for Union membership (although meeting these by no means equals to automatic qualification). Given our subject, the fourth criterion the Union's ability to absorb new members, will be disregarded.

As far as political democracy is concerned, Poland, the Czech Republic, Slovenia and Hungary all had parliamentary elections under international supervision, with regular and orderly handover of governmental responsibilities via new elections. Press freedoms are basically observed, nationality rights granted and bilateral disputes settled via international treaties. Unlike in the Baltics (except Lithuania) the Council of Europe has not found groups of citizens discriminated against. As far as market economy is concerned, OECD membership should suffice for testifying for it. And finally the economies' ability to stand competition has also been tested by trade, market and financial sector liberalisation. Unlike Southern Europeans, transforming countries have already opened up their economies prior to the accession talks. The Europe Agreements provided for a gradual but sustaining (first asymmetric) mutual market opening. Thus by the turn of the millenium everything what the European Economic Area could have offered, will have been attained. In fact, even more! The structured dialogue, initiated by the Essen Council of 1994 paved the way for a regular interchange among incumbents and candidates way above trade issues, covering i.a. environmental, financial, security and home affairs as well. In sum, it is unrealistic at best (and hypocritic at worst) to caution OECD member countries of a new market shock. In fact, one of the attractions of being in, rather than out, is the ability to co-determine the future shape of that

regulatory environment which is decisive for Central Europe as an investment spot. The market shock has already occurred and the price is basically paid in the form of transformational recession and the heavy losses in economic activity rates of the population.

It is worth noting that economic recovery and reorientation of commercial relations in Central Europe materialised without those massive international transfers (a second Marshall Plan) that has repeatedly been advocated by Jeffrey Sachs and the Economic Commission for Europe. This is, on its own right, an indication of the subordinate role of intergovernmental transfers, which is quite in line with overall international experience. Thus the size of those is unduely overrepresented in the debate on enlargement. The ability to absorb foreign private investment, by contrast, is certainly a direct indicator of maturity as well as of progress in economic transformation. In a consolidated economy reliance on what is 99.5 p.c. of international capital flows should rightly take precedence over the 0.5 p.c. Thus in theory new members may well reject any transfers from Brussels, as their investment attractiveness will automatically improve by the mere declaration of accession talks. Practically, this option is open only if everybody else rejects transfers, otherwise basic principles of the rule of law (i.e. even-handedness) would not be met. But the bottom line is that catching up is conditional upon involvement and integration rather than on the size, or even the occurrence, of unilateral transfers. The hard fact that recovery and structural change has been already mastered, without reliance on these, is possibly the most convincing argument in favour of cutting back the redistributory horse trading to its due size, also in enlargement debates.

It used to be fashionable to blame the Europe Agreements (EA) both at the analytical and the policymaking levels, basically for all economic pains of systemic change, and also for falling short of providing full membership. In reality these have proved, with the benefit of hindsight, one of the few efficient and mutually advantageous forms of assistance to Central Europe. In the trade section, despite much of the well known ambiguities and half-heartedness, these brought about a gradual and sustaining market opening on both sides to the degree it was possible under the given political constraints. The EA proved to be quite efficient as a means to fight protectionism whenever there was an administration, able and willing to make use of its provisions and procedures (Sapir, 1995). The association council, as a regular monitoring and consultation forum, proved particularly efficient a means to counter and even roll back creeping protectionism, or in the worst case scenario, signal high - policy - level warning signals against policies obviously contrary to the spirit and prospect of accession. This was the case with ongoing Polish reliance on quotas in the steel sector, their indiscriminate use of countervailing duties in the farm sector, and the discriminatory favouring of the Daewoo on Polish car market in exchange for investment. Likewise the Czech and

Slovak import deposits of 1997, the Slovak and Hungarian import surcharges of 1995 were criticised. The abolition of the latter could hardly have come about by 1 July 1997 without massive pressure from the association council.⁶

The revamping - actually the third edition⁷ of the law on competition has brought it fully in line with EU legislation in case of Hungary. Empirical analysis of the implementation of the deliberations of the 1995 law (Török, 1997) has demonstrated in detail that it is fully in line with EU practices, which is bad news. As the study (op.cit: 430-431) also notes critically, this implies notorious leniency on fusion controls and a very permissive stance on monopolies in the course of privatisation. This is not a surprising outcome, since supporters of US-style trust-busting have always been a minority, therefore some tasks specific to the transition phase (in building up and preserving contestability of markets) have been unattended. A cross-country analysis of the same area (Fingleton et al., 1996) comes to a similar conclusion for Hungary, while highlighting the major differences by the countries. As far as the other Visegrád countries are concerned, the book recurrently points to the drift between the very advanced level of transplanting formal rules and regulations on the one hand, and fairly timid (if any) implementation on the other. This applies primarily to the politically most sensitive areas like trade and privatisation, where competition agencies saved their integrity by simply escaping those spheres. This was though rational from the institutions' (and its leaders') points of view, but much less efficient from the macro (systemic) perspective.

A related issue is how large public companies adjusted to the market environment, or, as it is often postulated, how do they shape the fundamental qualities of the market order according to their own tastes. While quite a few theoretical papers were written up to show how it should be, it is, in the end, an empirical issue. Now it seems, that enterprise size matters more than the form of ownership in shaping the pattern of adjustment, except for strategic foreign owners, who can and actually do, act as textbook principals against their agents (managers). In the latter cases rearrangement and restructuring of assets, organisation and product lines is normalcy. In the 'national' large corporate sector the interesting finding is that in efficiency terms there is no across - the board - difference between the public and private sector companies in Poland (van Wijnbergen/ Pinto, 1995) and Hungary (Major, 1995). Whereas peculiarities of the Czech corporate governance make it hard to establish what is actually private, what is public, and what is in-between (non state) sector. Later overviews (Kolodko/ Nuti, 1997) emphasize the sustainingly improved performance of public companies in a competitive environment. In case of Hungary one by one analysis of the once notoriously

⁶ The MITT, the Hungarian chamber of trade, some unions and research organisations were fighting the rollback strategy literally until the very last day.

⁷ The first edition dates back to 1984, the second edition to 1990.

powerful 49 large public companies (Voszka, 1997) testify of a variety of adjustment methods, with those wanting to continue the bargaining with the authorities faring worse than average. As a rule, a combination of slimming and new acquisitions, sometimes also of public money, were the keys to survival. But the previous phase, when being a big company equalled to being the state is over, and more normal forms of scale economies in bargaining these.⁸ They no longer may define themselves as independent variables against their environment. Liquidations, bankruptcies, acquisitions as well as massive layoffs and the adverse publicity surrounding bailout operations constrain them very heavily in the 1990s. The latter - primarily how the bankruptcy legislation bites - has been varying considerably in the region. A part of the literature accuses the Hungarian policies of having been unnecessarily tough and thereby disruptive. Others consider exits from among large firms as a precondition for market clearing to make sense. But this debate must sound rather familiar to a West European reader.

Though not included in the Copenhagen criteria, the EU has always laid a great emphasis on the good neighbourly and compromising attitude among candidate members. This may explain the technically otherwise hardly justified interest in CEFTA as well as Romania's formal joining the Five in May 1997. This has, indeed stimulated more cooperative attitudes in the majority of cases, including the signing of long overdue *Grundverträge* between Hungary and Slovakia as well as Hungary and Romania. The CEFTA is certainly not the frequently cited training ground for the EU, as it is a set of bilaterally different arrangements managed by the national agencies.⁹ Quantitative analysis of the first five years (Réti, 1997) is indicative of a modest recovery of mutual trade due to gradual liberalisation. Meanwhile the high share of exchanges financed by western banks, the virtual lack of capital flows, and the low level of interfirm contacts (except for among affiliations of multinationals) indicate the clear difference of CEFTA from the intra-EU type of microeconomic integration.

Meanwhile it would also be misleading to belittle the role CEFTA played in institution building. Closer analysis of the measures, adopted partly as a consequence of 1994 WTO (Csaba, 1996) indicates the very wide application of liberties and procedures, that could not (yet) be globally accepted, still may be extremely relevant in civilising behaviour of authorities and lobbying groups alike. For instance public procurement procedures, the cumulation of inputs from CEFTA countries (as of domestic origin), reliance on countervailing duties and other more

⁸ Large companies, like Chrysler, Creditanstalt, Alitalia or Credit Lyonnaise exert certainly more leverage on public finances, than a corner shop. But it is not the same as the intertwining typical of the one-party state.

⁹ Messerlin (1997) goes as far as questioning the WTO conformity of this arrangement due to its basically bilateral qualities.

sophisticated protective measures as against the previously predominant use of quotas and licensing, the introduction of the obligatory consultation and preliminary in formational procedures will gradually exert a very useful and palpable civilisatory influence of traditionally inward-looking, selfish and non-cooperative agents. Publicity and procedures will outweigh the previous behind-the-scene talks, which is important, even if the impact is not immediate.

Exchange rate policy is also not explicitly mentioned among the Copenhagen criteria. Implicitly, however, as a derivate, as ability and willingness to apply the full *acquis*, already puts requirements on candidates. This should not be interpreted (and, at least by commission officials, has never been interpreted) as taking Maastricht stage III as an entry card for anybody wishing to join. But precisely the current distance of inflationary performance of Central Europeans from EU average make the magic Maastricht numbers quite important points of orientation for candidates.

Owing to the lengthy accession period it should be trivial, that trends in, rather than the states of, individual indicators which really matter. A continuously falling trend is thus more relevant than its actual state at the time of accession. It is worth noting, that on fiscal criteria, but also on the trend of long term interest rates Central Europeans outperformed incumbent EU members (Fischer et al, 1997). On the inflation front, progress is much slower, due to a number of reasons typical of middle income countries. The enforced floating of the Czech crown, the foreseeable devaluation of the Ukrainian *hryvna*, the devaluation of the Romanian *leu* are all indications that arbitrarily declared exchange rate stability is not a sustainable systemic option (as yet). As Yugoslav and Italian experience recurrently demonstrated, while anchoring may be inevitable in the introductory phase of stabilisation, fixed rates survive only if the entirety of macroeconomic fundamentals are right. This means primarily sustaining success in arresting inflation, rather than the other way round (as the slogan of 'importing credibility' would imply).

EU countries know it only too well how hard a job it is. Thus it is not realistic to expect Central Europeans ready for EMU already at the time (or even during the advent) of their accession, since they will probably not yet be in the position to take advantage of 'tying one's hand'. But this should not be seen as a very grave problem when it is probable, that not all incumbent EU countries will make it to the first group of members in the currency union. The arrangement to be elaborated for the 'ins' and the partly self-declared¹⁰ 'outs' can easily be transferred to the

¹⁰ Sweden, Britain, probably Denmark will not join in, should the EMU in 1999 really materialise; Greece and perhaps Italy will also likely to be 'outs'.

newcomers. This makes suggestions for a phased membership (as e.g. Tichy, 1997) fully out of date.

Central Europeans take the Union as a point of orientation, thus a strong, well functioning EU with a stable currency rather than anything else what they are for. The survey of their progress made in the various areas covered by the Copenhagen criteria shows: these economies should fit fairly well into an EU that allows for the competition of systems. A graded membership is unrealistic not only because it would only perpetuate currently observable lags and distortions, but also because of the evolution of the *acquis* over the last decade. Single market arrangements expanded by Maastricht leave little room for the replication of 6-7 years interim periods and the wide use of derogations in the economic sphere¹¹, as was the case with Southern enlargements. The history of trade protection is also a history how temporary arrangements solidify and lead to misdevelopment and maladjustment. Thus a flexible interpretation is though needed, still taking over the full *acquis* is the only realistic way to avoid the greater evil. Paying the price of adjustment is certainly the smaller amount. And in our survey, as long established methodological procedures are not given up for policy statements, we could not find a single area where the distance of newcomers to incumbents would qualitatively differ from the already available North - South differences within the EU. And is it realistic to expect the Czechs or the Estonians to be more of a problem than the Greeks or the Spaniards? In sum, the phased membership idea is not only a legal nonsense, but also based on impressionistic economics at best.

Skeletons in the Cupboard?

Having presented the critique of most common fears from the dangers of the 'East' does not imply a rosy picture, free of any problem. The second message of this paper is on what this author perceives as major, though mostly covert or neglected, trouble spots in and for Central Europe¹² should full membership materialise in the medium run. The list presented below is by no means exhaustive. It is conceived under the narrow, self-limiting angle circumscribed in the introductory section, and does not attempt to answer (or cover) all major problems and unresolved tasks of transformation. It is fairly clear that systemic change and world economic adjustment will continue way after accession, further public choices will have to be made, and the entire adjustment of Union economies to the challenge of Asia will have relevant implications for Central Europeans too. But these issues lead beyond

¹¹ In the environmental, social and maybe in some other non-economic areas derogations may become feasibility side-conditions.

¹² The other side of the same coin, viz. how the EU should (help to) cope with these, could be a subject of a different paper.

the scope of the present paper, devoted to proofing the maturity of transforming countries for EU membership, and problems therein.

- One of the structural weaknesses in transformation has been the inadequate development of agricultural market institutions and its infrastructure. As a recent survey article (Fertő, 1997) has convincingly demonstrated, even in Hungary, where the farm sector used to be relatively marketised under the socialist period, very little of the institutions typical of contemporary West European agriculture emerged or were organised. In reality, traditional preoccupation with quantitative and income redistributory targets prevails. Hungary's hopeless debate with its WTO partners on agricultural export subsidies in 1996/97¹³ is possibly the best direct indication of how little all agents, active in this area, have understood the logic of managed markets. This may, in turn, become the source of several undesirable developments:
 - The lure of simply copying EU CAP arrangements in the name of harmonisation will increase. Not only the forthcoming EU reforms make this uninspiring, but simple economic calculation and realities of international food markets, saddled with chronic overproduction, render this a less than desirable option;
 - lack of regulation may (re)create wide fluctuations that are (has been) typical features of early capitalist market order, with the concomitant social and economic costs;
 - environmental concerns may simply go under both in the over- and in the underregulated scenario;
 - cultural, regional and way-of-life considerations call for measures enhancing the capacity of rural areas to retain their population. This requires decoupling á la MacSharry, i.e. regional and income support schemes irrespective of farming output performance. This is a serious challenge, both for government administration and interest representation. Inability in managing this task may lead to overinvestment in non-marketable production with simultaneous underinvestment in regional infrastructure and environment-protection. The wrong pattern will be prone to reproduce itself.

¹³ The dispute ended with a compromise, allowing for the years until 2002 (rather than the original 1997) for phasing out direct export and (non green box) production subsidies in Hungary, in line with the 1994 WTO commitments cf. Népszabadság, 18 July 1997.

- Financing and organising regional policies. This area has traditionally been poorly integrated into governmental decisionmaking in Central Europe. In Hungary, municipalities, the Ministry of Interior, the Ministry of Transport, Communication and Water Management, as well as the Ministry of Environment have a responsibility for these. The agricultural department considers all these as concurring establishments in its fight for scarce resources. Local municipalities were endowed with far-reaching proprietary rights by the 1989 Constitution, supported by decisions of the Constitutional Court in their favour.¹⁴ However, in practice these bodies are able and willing to enforce their rights to a varying degree. The major problem is, that in depressed areas, where more entrepreneurial spirit were required, municipalities, too, are underfunded and idle. Contrary to Scandinavian practice, these mostly lack both the ideas and the administrative capacities needed to tap EU funding. It is quite likely that they will be able to draw only a fraction of those entitlements that would accrue to them under (any) Union arrangements.

The organisational splintering is exacerbated by the survival of the ratchet principle in fiscal planning, both at ministerial and municipal levels. As a consequence all available funds must be spent during the calendar year,¹⁵ therefore no reserves are built. Should external money be forthcoming, the own contribution would be hard to find, as the potential reserve had already been earmarked for a competing claim, safely foreseen by the fiscal planner. Thus waste coexists with shortage, and none can be cured, as known from the command economy period.

Experience with the first year of the public procurement act amply demonstrated, that even central authorities find it hard to cope with the new, more transparent and competitive procedures.¹⁶ Municipalities, to a large extent, have an even more risk-shunning and competition-averse tradition. Reliance on external consultancy is sporadic and random. One of the positive contributions of EU accession might be that sufficiently lucrative sums may be targeted, that will already worth the effort needed to ensure their availability. The latter could be a civilisatory accomplishment, owing to its spread and intensity alike.

- Fiscal policy suffers from a number of shortcomings. Its information base is incomplete at best. In case of Hungary there is no consolidated and up to date balance sheet of state property. Double accounting of external debt was

¹⁴ The decision of 1995 outlawed fiscal decrees aiming at excluding townships from the privatisation revenues of the State. In a similar vein, a 1993 decision established municipalities as fully-fledged proprietors, equal to private persons, as owners of flats.

¹⁵ The introduction of the Treasury Office only reinforced this feature in public organs.

¹⁶ When buying tanks from Belarus the Hungarian minister of defence could simply disregard the law on public procurement in 1996.

discontinued only from 1997. The expenditure side is predetermined by political overcommitments, implicit debts (as on the pension system) and inherited organisational setup. Functionality, costcontrol and personal responsibility for misuses of funds (overspending or arbitrary regrouping) is nonexistent. Reference to the fact that many other countries suffer from the same ills does not cure it. On the revenue side the textbookcase (as counter-indication) of high nominal tax rates coupled with their lax administration and many exemptions proliferate, despite tax reforms, having lead to a considerable growth of implicit tax burdens (Newbery, 1996). Modest or no improvements on these structural affairs may discount the value of some of the impressive cuts in public spending ratios in Central Europe. EU countries are the best examples, how unreformed fiscal structures recreate the debt problem, owing to the rigidity of the expenditure side.

This might pose a difficulty not so much in terms of the Maastricht debt criterion (which may require some further efforts from Polish and Hungarian fiscal authorities, though currently do not look unattainable).¹⁷ Pension and health care reforms are likely to make previously implicit debts explicit. This will create a problem, should reforms improving both the revenue and the expenditure side, not be forthcoming. Lowering rates and severing administration is certainly the wayout, though that is also easier said than done.

- Sustainability and stability of economic policies may or may not be forthcoming. One of the pleasant surprises in the 1989-97 period in the three most likely future EU members of Poland, the Czech Republic and Hungary has been the truly remarkable stability of the overall policy line among, and above, the frequent twists and turns of their daily politics. The explanation for this is different by the country. Whereas in the Czech case virtually the same professional and political team has been dominating from the very outset, in the Polish and Hungarian cases a broader professional consensus, plus a relatively narrow circle of recruitments for the post of minister of finance and the governor of the central bank ensured this stability. But the first phase of transformation - transition - was dominated by issues where professional consensus could be established in a very broad spectrum, as long as the fundamentals of any market economy are common, thus disagreements can only be marginal. Favouring a predominantly privately owned economy, an independent central bank, or moderate rather than high levels of inflation do not require major economic insights: they have been part and parcel of the public consensus. Once these fundamentals are right, the room for disagreement, typical of western societies are likely to emerge, but in a context where the priority (or culture) of price

¹⁷ The Polish debt/GDP rate in 1996 was 60 p.c. the Hungarian 75 p.c.: The Czech number of 14 p.c. seems to be non-consolidated (covering central budget only) thus it is not comparable to the first two numbers.

stability is not (yet) as strong as it has been in most of the OECD area in the last 15 years. Some main social forces have been building up their political capital on blaming those 'idolising' price stability in particular and monetary indicators in general. Not only unions and chambers of industries or local municipalities may be the points in case. The Czech social democrats, all the Hungarian centre right parties, as well as the party alliance of Solidarnosc and also the Peasant Party (a constant king-maker in Polish politics) adopted old-labour (ancient Keynesian) growth generating platforms. Experience with the first 6-7 "transition" years have set the levels or inflationary expectations very high, while governmental credibility is anything but exceptionally high in the three frontrunner candidate countries. Not only public, but also professional understanding of, and support for, noninflationary growth as the key to policy sustainability is far from general. The myth of higher inflation allegedly enabling a less painful and socially lower cost way of structural adjustment is still widely cultivated. Added to the experience of inflation, having stuck at double digit levels in all transforming countries except Croatia, this overall atmosphere may be conducive to policies and expectations, resulting in higher rates of inflation than would be technically 'inevitable'. The danger in the three frontrunners is not one of Latin-American type of populism, but lack of sufficient further effort and even firmer deliberation needed to bring down moderate inflation to lower single digit levels by the time of accession. Only the latter accomplishment may validate the candidates' claim to be on the way to a degree of financial stability, so that they may qualify for EMU in a time, credibly foreseeable at the point of their eventual accession, say around 2003.

- As long the previous points caution against overoptimism on the inflation front, exchange rate stability can not, and indeed, should not, be declared by fiat. All the less so as trade balances and current accounts of the candidate countries do not seem to be strong enough to cope with any amount of real effective appreciation of their currency. This is not to imply any leniency in exchange rate policies. However, normative theoretical statements should, at the policymaking level, be reconciled with realistic target setting. Introducing import surcharges (as in Hungary in 1995) or import deposits (as in the Czech Republic in 1997) or the continued use of quotas (as in Poland in 1996) in order to avoid devaluation are clearly more discriminating, distortive and also less adequate alternatives. A gradually decreasing crawling peg seems to be the relatively least harmful bridging solution, until improvement in the fundamentals allow for the rate of exchange to stabilise. This is unlikely to be an abrupt jump. On the contrary: arbitrary fixing may only lead to discretionary devaluations with the resultant loss of credibility for the entirety of policy. Stressing the relevance of EMU, as part and parcel of the acquis, meanwhile may play an important educational role in cautioning Central Europeans against leniency on the exchange rate and inflation fronts. The perspective of Union membership, on the other hand, may

provide precisely that impetus which is needed to overcome reform fatigue and to steer politicians to strive for more in their fight for financial rigour amidst recurring pressures for new and new spending sprees. Meanwhile the error of mixing up ends and means in thriving for exchange rate stability should also be avoided, as premature declarations of victory (over inflation or in having mastered privatisation and restructuring tasks) may only backfire.

- Emphasising the social dimension of Europe, widespread malpractices in incumbent members on their labour markets may easily trigger attempts at the legislative level to emulate in Central Europe those arrangements that make EU labour markets so rigid. Polish and Slovak experience in the 90s already indicate: high growth rates of GDP alone fall short of taking care of massive (double digit) rates of unemployment. Labour legislation is easy to pass, especially when wide coalition parties (*Volksparteien*) govern, but by the same token the deregulation of the same area is next to impossible. The only prudent choice Central Europeans may have is to avoid overregulation and lay emphasis on forms that enhance employment, like small and medium size business, seasonal and part-time work, subcontracting and working at home (a Japanese practice much supported by the spread of personal computers). Lowering the social security burden of employers may also be indispensable if more jobs are to be created. Limitations to fire are also limitations to hire. The more widespread is the use of tripartite/corporatist practices in setting wages across the board, the smaller is the chance of 'outs' ever to get in, further the likelihood of structural conservatism also increases.¹⁸ The slogan of social Europe, coupled by one-sided emphasis on unification of everything, with reference to the levelling the playing field argument, might be particularly detrimental for the less developed Central Europeans. While they have no leverage over shaping the *acquis*, they do have a leeway in organising their own arrangements, where marginal productivity of labour considerations may act in an efficiency enhancing manner. Anchoring social rights in the Constitution, as it happened in Poland in 1997, and has been attempted in Hungary in 1995-97, can only lead to claims that no government can come up for, but it can also trigger unsustainable and anti-competitive legislation.

Consolidation of public finances has been practiced by moving along the lines of smaller resistance. Cultural and educational establishments have significantly smaller bargaining power than, say, miners, air traffic controllers, or peasants. This has led to wearing down and bleeding out of universities but also much of the secondary education. Private supply of educational services focus on 'how to do' courses, post-secondary degrees and immediately useful market knowledge.

¹⁸ This is not necessarily the case, as Scandinavian unions were instrumental in mastering some of the sectoral crises in the 70s and 80s.

Though necessary, but hardly sufficient to cope with the numbers of school-leavers, not being qualified enough to join in the fight for jobs, where language skills or computer knowledge is required. These hundreds of thousand are though unlikely to flood Ireland or Portugal as job-seekers, but their presence may create a social strain. Poorly trained intellectuals, not prepared for the competitive conditions may only multiply this problem. In sum, a large segment of (partly) involuntary rent-seeking population (on the Spanish model) may create a lasting problem both for the new entrants and the Union, and not only in terms of financing. The tighter is labour market legislation knit in the name of social justice, the less likely these people could ever be integrated into their respective societies, partly for their inadequate cultural conditioning.

- Qualifications in the state administration may, though well be relatively high, but its nature and pattern is often incongruous to what the multinationalism of the Union would presuppose. In Hungary, for instance, it is very rare to find anybody speaking and writing with a good command of both French and English. In many departments technical and (mostly out of date or narrowly national) legal or economic knowledge is made up by experience, whose relevance is often questionable under the new conditions. Multinational lobbying is a by and large unknown phenomenon. EU affairs are often seen as a prerogative of the Ministry of Foreign Affairs, and the initiative as well as the expertise to enter foreign markets is often missing. The administrative capacity to manage (rather than just to translate and promulgate) Community legislation is severely limited, and may prove to be one of the narrowest bottlenecks for integrating Central Europeans into the EU. The more seriously is the idea of subsidiarity taken, the graver will be the traditional lagging of municipal administrations behind their metropolitan/national counterparts. In a way it is surprising how little substantial progress is made in these areas despite the proliferation of courses on and more travels to Brussels.
- A realistic cost-assessment of enlargement is non-available. Whereas cost-estimates on the Western side are numerous, and the related number-gazing has developed into a rewarding and popular business, comparable efforts on the Eastern side are not yet known. This is explicable on two grounds.
 - As not even the shape of post-2000 EU emerged, it is next to impossible to make even the first run of a serious and credible cost/benefit calculation. Individual experiments made in Hungary all employ a 1992 or 1994 *ceteris paribus* assumption, especially as far as procedures and entitlements are concerned. The only thing which is sure at the time of writing is that both are likely to change. In one leakage the share of population supported by payments from structural funds should decrease from 51 to 35 p.c. of total

EU spending, moreover this amount should suffice to satisfy old members and new entrants as well (Wulf-Mathies, 1997). CAP entitlements are likely to be restructured so as to focus support on small establishments on remote areas, irrespective of production levels, while previously supported medium and large farms, producing standard products (and oversupplies) are likely to lose all or nearly all subsidies related to output (Die Welt, 10 July 1997). If both plans materialise, even only in part, the calculation based on *ceteris paribus* assumptions may turn out to be totally irrelevant.

- A first consolidated assessment of total costs put it in the range of 10 per cent(!) of Hungarian GDP the cumulated outlays needed additionally over and above the 1997/98 levels earmarked in the Hungarian budget (Kádár, 1997). This estimate, produced by the chairman of the budget committee of the Hungarian legislation, may be seen as an upper limit in a pessimistic scenario, where the shortfall of customs revenues is not made up for more intakes from indirect taxes (due to the expansion of economic activity), further profit repatriations jump from the current 100-150 mn dollars p.a. to 1.5 bn dollars, i.e. ten times. Furthermore costs of NATO expansion are put at maximalist levels of modernising armaments, but without reliance on possible aid shipments. All in all, as these examples show, different assumptions may produce wide variations in actual numbers. Moreover experience teaches that such occasions allow for major clashes of lobbying interest. Each department or area may feel: it's time to make up for all it lost in the previous decade. Modernising the entire Hungarian air defence system, or recultivating all industrially polluted areas, may equally be put on the agenda. Depending on the outcomes of these infights the bill may even exceed that derived from technical considerations voiced above.

But in the end of the day the problem here is that Central Europeans have currently more unknowns than equations, thus the solution can just be a guesstimate. Should an equal number of equations emerge, then the policy task will not have been mastered yet. Namely that sizable reserves for mastering previously nonexistent tasks have to be built into an overstretched budget, already saddled with the task of major future (additional) expenditure cuts. Whoever is in government, such a technical must will be close to a political impossibility. Thus even if costs can be realistically assessed, the raising the funds for their coverage will hardly be a trivial job, especially if disinflation has to accelerate meanwhile.

- Following Maastricht the implementation of Schengen Agreement is part and parcel of the acquis. This problem is particularly serious for Hungary, although the financial side of instituting and administering efficient common border

controls will surely be a burden for Poland as well. Hungary is not an island, and her neighbours who will unlikely to be EU members in the future are neither Norway nor Switzerland. Hungary has a strong interest in retaining permeable borders, meanwhile has an equally strong stake to be part of the common home affairs and justice arrangements, and all measures fighting terrorism and organised crime. Hungary and Poland received related calls (but no support) to ward off drug trafficking and trade with people. Whereas the commonality of interests would justify major financial contributions of EU incumbents to fight organised crime, it seems unlikely that the required amounts will actually be transferred. A poor physical infrastructure may dilute much of the substance of Schengen, while possibly nobody wishes to re-erect the Berlin Wall on the green borders in the heart of Europe in the name of fighting the spillover of mafia-capitalism.

- Last but not at all least the quality of regulation should be mentioned. As an Austro-Soviet heritage, detailed and frequently changing rules with many loopholes and wide room for bureaucratic interpretation for individual cases is prevalent in all the three countries. Therefore regulation in economic theory, but also in public debates, is rarely seen as setting rules for everybody and for 'eternity'. Most laws address specific situations and issues, thus they can't be kept stable in a changing world. Legal instruments are often instrumentalised to settle income redistributory conflicts, restrain market access, or sustain (self-employ) bureaucratic organs, or worse, serve prime political objectives of a given election cycle. This is coupled with an underfinanced and underequipped judiciary, which can be politically leveraged. Judges try to keep out of truly contestable issues, be that political or business conflict. Procedures allow for cases to be settled in 3-4 years. A large number of rules coexist with their lax implementation. In public perceptions legal fetishism and disregard for prescriptions and proscriptions is nearly as widespread as in Southern Europe.

Rule of law and law-abiding behaviour can certainly evolve, not, however be declared. Therefore it is likely that the sanctions and enforcement mechanisms of the Union, as well as the experience in regular business relations will help enhancing the observance/implementation of regulation. This is certainly a call to be less perfectionist with issuing new EU regulations. But even under the best of circumstances, a long interim period of trials and errors in applying legal discipline and the rule of contracts will be required.

Public perceptions of the role of law as well as administrative habits may finally change, but only slowly. This finding, that could be observed also by Southern enlargement, will be important in shaping realistic expectations on the Union side vis-à-vis the new members.

Outlook

This paper consists of two contradictory parts. The first part is an attempt to prove: those obstacles to accession that are most widely discussed in the literature are either based on bad economics, or underestimate progress that has already been accomplished by the frontrunning transforming countries. In the second part ten less spectacular, though deeper rooted problems are listed to show some of the real trouble that is likely to come only after accession. The solution to the paradox is involvement and integration, not money. If there is a perspective, those immediate tasks that are faced by the policymaking level are relatively easy to manage. Those part of the problems that relate to habits, inherited stocks and social intangibles may only change in an evolutionary manner, i.e. slowly. In facing these, both sides may well prepare for the post-accession period, when quite a few of the inherited problems will remain with us. There still is a room for optimism: involvement and integration does not equal to pouring money into a bottomless barrel, or hectic governmental activism. On the contrary: it is about setting free the mechanisms of self-regulation, by which tens of thousands of agents adapt new ways and welfare improves. When Spain, Portugal or Ireland joined in, they faced similar problems. And even Greece's 4.9 per cent inflation not only may, but actually does indicate a major change in those deep-rooted habits, which social scientists sometimes consider as constant. Central Europe has already mastered some momentous tasks, like reorientation, liberalisation and privatisation. Integration will conclude the second phase of transformation, which is, to a large degree, ahead of us. But the tasks yet to be solved should be tackled anyway. Involvement may provide precisely that impetus, which is needed for the policies to take effect. And the remaining task is momentous, just because it is non-trivial and it is not well perceived by the transforming societies themselves either.

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